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Changing Money: Foreign Exchange Reform in the People's Republic of China

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Changing Money: Foreign Exchange Reform in the People's Republic of China

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"You can't buy those grapefruit. But if you change money, I'll give them to you."[1]

I. Introduction

Westerners who have been to the People's Republic of China (also referred to as the PRC or China) should be familiar with the uncanny ability of some Chinese to pronounce the English words "change money." Only foreign investors in China, however, have felt the pinch of these words. This pinch results from the pervasive controls the PRC has placed on foreign exchange.

China itself, however, has recently "changed its money" in a fundamental way. The State Council's decision on further reforms of China's foreign exchange system[2] (the Foreign Exchange Reforms) represents a move of substantial importance to investors because it remedies a discriminatory exchange rate system and will affect the administration of enterprises in China. This Note provides an overview of the PRC's foreign exchange system before and after the reforms, with special attention to the problems of foreign direct investment. It is maintained that, unlike the 1986-87 foreign exchange provisions designed to help investors, the goal behind the current reforms is to

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1. Amanda Bennett, *As Peking Wrestles with Devaluation, Currency Black Market Dealers Thrive*, WALL ST. J., Dec. 19, 1984, at 32 (statement of Chinese fruit vendor to an Australian student).

2. The regulations were officially announced by the People's Bank of China on Jan. 1, 1994. A translation of the announcement was printed in English in the Business Weekly Supplement to China's official English language newspaper, China Daily. *China: Central Bank's New Reforms of Foreign Exchange System*, CHINA DAILY, *in* BUS. WK., Jan. 16, 1994 (China Daily Supp.), *available in* WL, Int-News-C Database [hereinafter *Foreign Exchange Reforms*].

reestablish central control over the foreign exchange flows of various domestic business entities and regions.

To help appreciate the impact of the Foreign Exchange Reforms, Part II of this Note follows the Chinese currency from a paradigm of central control at the founding of the People's Republic to its splintering into three separate exchange rates and markets thirty years later. In tandem, it examines the development of foreign direct investment[3] in China and the PRC's attempts to address investors' complaints of foreign exchange difficulties with methods such as swap markets and import substitution. Part III illustrates that the reform of the foreign exchange system is an effort to regain central control over unrestrained capital flows by both state enterprises and provincial governments, noting the failure of other government expedients taken to establish such control, save for one exception in stabilizing the currency. It is argued that this success inspired the Foreign Exchange Reforms, which are presented and analyzed. The final section concludes with a look back at the effects of the reforms on foreign direct investment.

II. Previous Foreign Exchange Controls (1949-1993) and Foreign Direct Investment

The level of foreign direct investment in China has risen dramatically in recent years. An estimated US$110 billion dollars of foreign investment was contracted in 1993 alone, with over US$25 billion actually expended.[4] These amounts are almost equal to the combined amounts expended in the preceding fourteen years since the "open

3. Foreign direct investment is active investment in which the investor has a voice, as distinguished from portfolio investment, which is passive in nature, and involves diversification rather than control. PAUL H. VISHNY, 1 GUIDE TO INTERNATIONAL COMMERCE LAW § 5.01 (1993). The foreign direct investment referred to in this Note is generally limited to three types: equity joint ventures, cooperative (or contractual) joint ventures, and wholly foreign-owned ventures. Investment in these enterprises is generally referred to by this author as "foreign direct investment," and these firms collectively referred to as "foreign invested" or "foreign funded" enterprises (FIEs or FFEs by commentators).

Following these commentators, this note does not discuss foreign direct investment in the forms of "representative offices and contract for construction projects, management services, processing and assembly operations, compensation trade arrangements, leasing of equipment, and licensing of technology, and . . . develop[ment of] offshore and onshore oil and other mineral resources in China." Jerome A. Cohen & Stuart A. Valentine, *Recent Legislation Assisting Foreign Investors to Solve Their Hard Currency Problem: Import Substitution and Other Options*, 1988 B.Y.U. L. REV. 519, 519 n.2 (1988) [hereinafter *Hard Currency Problem*].

4. *Foreign Investment in China Increasing Rapidly*, Xinhua Gen. Overseas News Service, Jan. 28, 1994 (quoting Wu Yi, PRC Minister of Foreign Trade and Economic Coopera-

door" reforms were first implemented.[5] Meanwhile, the PRC experienced back-to-back years of thirteen percent overall economic growth.[6]

This influx of foreign direct investment is attributable in large part to China's establishment of a supportive legal framework.[7] For example, Chinese-Foreign joint ventures are given sizeable tax breaks.[8] In addition, the PRC established areas of preferential treatment for foreign direct investments, known as Special Economic Zones (SEZs) and Economic and Technological Development Zones (ETDZs), which offer both foreign and domestic investors measurable preference in taxation, employment, utilities, and other business considerations.[9] These areas have served as testing grounds for reforms of business law and trading practices, including foreign exchange pro-

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tion (MOFERT)), *available in* WL, Int-News Database. These levels represent respective 90% and 134% increases over 1992 levels. *Id.*

5. *Id.* For a further discussion see *infra* part II.B.

6. Marcus W. Brauchli, *Tempering of Investment Boom in China Signals Return to Sounder Growth There*, WALL ST. J., June 16, 1994, at A12.

7. For a full discussion of the history of and motivations behind foreign direct investment in China, see Jerome A. Cohen & Stuart J. Valentine, *Foreign Direct Investment in the People's Republic of China: Progress, Problems and Proposals*, 1 J. CHINESE L. 161, 163-78 (1987).

8. Qualifying joint ventures can receive two tax-free years followed by a fifty percent reduction in the three succeeding years. *Id.* at 168-69.

For a more complete discussion of China's tax system see Timothy A. Gelatt & Richard D. Pomp, *China's Tax System: An Overview and Transactional Analysis*, *in* FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PEOPLE'S REPUBLIC OF CHINA 42 (Michael J. Moser ed., 2d ed. 1987) [hereinafter FOREIGN TRADE]. Along with the Foreign Exchange Reforms which are discussed in this Note, the PRC has also made major reforms in its taxation system that may alter some of the benefits enjoyed by foreign investors in China. For a discussion of these reforms see Sabine Stricker, *China's Tax Reform: Tax Reforms in China Include One System for Domestic and Foreign Enterprises*, 5 J. INT'L TAX'N 117 (1994).

9. Special Economic Zones (*jingji tequ* in Mandarin Chinese) were first established in 1979 in three municipalities: Shenzhen, Zhuhai, and Shantou in Guangdong province. Elison Pow & Michael J. Moser, *Law and Investment in China's Special Investment Areas*, *in* FOREIGN TRADE, *supra* note 8, at 199.

Economic and Technical Development Zones (ETDZs) are special regions within other cities and areas that have since been "opened up" but lack full SEZ status. *Id.* at 234. In ETDZs, investors enjoy comparable preferential treatment to SEZs. *Id.* However, ETDZs lack administrative independence and are limited to industries best suited to the area (SEZs can also engage in other commercial activities). *Id.*

For a general discussion of both SEZs and ETDZs see *id.* at 199-269; Owen D. Nee, Jr., *China's Special Economic Zones and Fourteen Coastal Cities*, *in* LEGAL ASPECTS OF DOING BUSINESS WITH CHINA at 445-88 (1986) (Practicing Law Institute, Course Handbook Series No. 405, A4-4173); RALPH H. FOLSOM ET AL., LAW IN THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL 387-91 (1992).

visions.[10] However, China's apparent intent to assist foreign investors does not negate "[t]he complexity of China's foreign exchange [which] has become one of the greatest challenges for outsiders wishing to do business in the country."[11]

A. *Stabilization and Central Planning (1949-1978)*

1. *Birth of the People's Currency*

At the birth of the People's Republic of China in 1949, the country was in a state of economic chaos.[12] To regain control over the economy, the new central government unified the banking system[13] by establishing a national bank, the People's Bank of China (PBOC),[14] and a national currency.[15] The currency was named *renminbi* (literally the "people's currency" in Mandarin Chinese) with its unit referred to as the *yuan*.[16]

The central government set national policies,[17] and large district governments carried out foreign exchange control using their own

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10. Two commentators write:

> A . . . function of the SEZs is to serve as centres for education and experimentation. Isolated geographically, the SEZs are viewed as "hothouses" of economic development in which China is able, within a controlled environment, to gain experience . . . with economic reforms that may be adopted elsewhere in China. Chinese publications have frequently elaborated on this theme describing the SEZs as pilot projects . . . .

Pow & Moser, *supra* note 9, at 201.

11. Harry Sender, *Two Price China*, FAR E. ECON. REV., June 17, 1993, at 64.

12. The economy was in a state of hyperinflation at the fall of the Nationalist (Kuomintang) regime. Anita Santorum, *Country Study: China, 1949-88*, *in* MONETARY POLICY IN DEVELOPING COUNTRIES 187 (Sheila Page ed., 1993).

13. According to one source, more than 900 private banks existed before 1949. *Id.* at 187.

14. *Id.* ("The People's Bank of China was established in 1948, was designated the central bank soon after the revolution.").

15. JUNE TEUFEL DREYER, CHINA'S POLITICAL SYSTEM: MODERNIZATION AND TRADITION 175 (1993) ("It was further announced that anyone indulging in currency speculation would be punished. Several well publicized executions convinced doubters . . . .").

16. INTERNATIONAL MONETARY FUND, ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 107 (1981). Within 10 years of 1949, the *renminbi* was the only remaining currency circulated in China. William Triplett, *The Banking Industry*, *in* DOING BUSINESS WITH CHINA 190, 191-192 (William W. Whitson ed., 1974) ("Prior to 1947, the Communists issued various currencies in the regions of their authority . . . . The last non-RMB [*renminbi*] notes were withdrawn from Tibet in 1959.") (footnotes omitted).

17. Although the Chinese adopted the Soviet central planning model for their economic policy, the actual level of planning was substantially less detailed than other centrally planned economies. Donald C. Clarke, *What's Law Got to Do With It?: Legal Institutions and Economic Reform in China*, 10 UCLA PAC. BASIN L.J. 1, 5 (1991). For a concise introduction to Chinese economic reform, see *id.* at 4-15.

provisional measures.[18] Two main foreign exchange policies were in effect during this period, one forbidding circulation of foreign currencies within China and the other providing for state supervision over all inflows and outflows of foreign exchange.[19] Thus, currency use within the PRC was highly controlled.

2. *Low Levels of Foreign Direct Investment*

Direct investment by foreign firms was not encouraged during the first three decades of the People's Republic of China,[20] and thus China had no impetus to develop accommodating exchange mechanisms. After the Great Proletarian Cultural Revolution,[21] (the "Cultural Revolution") China began to seek more foreign cooperation and technology, but still discouraged direct investment.[22] As of 1978, the inflow of direct investment by foreigners was less than $300 million a year.[23]

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18. CHENG YUAN, CHANGING PATTERNS IN CHINESE FOREIGN TRADE LAW AND INSTITUTIONS 45 (1991).

19. *Id.* at 45-46.

20. *See* Cohen & Valentine, *supra* note 7, at 163 ("With a few exceptions of a rather limited nature involving Soviet, East European or overseas Chinese capital, for the first three decades of its existence the PRC remained hostile to foreign investment.") (footnote omitted). *See also* Liu Hongru, *Developments in the Reform of China's Banking and Financial Systems*, 2 J. Chinese L. 323, 338 (1988) ("Prior to 1978, China's economy was closed to the outside world and financial contact with foreign countries was minimal.").

21. The Cultural Revolution was a complex social upheaval engineered by PRC founder Chairman Mao Ze Dong which "wrought terror and disorder on China." JONATHAN D. SPENCE, THE SEARCH FOR MODERN CHINA 439 (1990). Dates are generally given for the movement as 1966-1976. *Id.* at 791. During the Cultural Revolution, banking activities were dismissed as bourgeois and funds were distributed arbitrarily. Amy E. Yates, Comment, *The Role of the Black Market in China's International Financial System*, 7 Nw. J. INT'L L. & BUS. 833, 835 (1986). For a comprehensive discussion of the history of Modern China, see SPENCE, *supra*.

22. Cohen & Valentine, *supra* note 7, at 164 ("[D]espite its interest in these other forms of cooperation [contracts to import technology], for a generation China did not utilize FDI [Foreign Direct Investment] as an additional means of importing technology.").

23. *Sino Xenophilia, Survey: When China Wakes*, at 13, *in* ECONOMIST, Nov. 28, 1992.

3. *Inconvertibility of the* Renminbi

Furthermore, inconvertibility,[24] an aspect of the centrally-planned economy,[25] was anathema to foreign investment. Therefore, rather than convert *renminbi* into foreign exchange, the PRC relied on barter (also known as countertrade) with Communist countries,[26] or

24. Because of the plethora of controls placed on foreign exchange in the PRC, the *renminbi* is generally referred to as "inconvertible." Currency convertibility is the ability to exchange one currency for another without many governmental hindrances. *See* RUDI WEISWEILLER, HOW THE FOREIGN EXCHANGE MARKET WORKS 97-98 (1990). Certain countries, like Switzerland, allow for full convertibility—letting any holder of domestic currency demand and receive foreign currency at any time. *Id.* Other governments provide more limited forms of convertibility, with accompanying regulations. *Id.* at 98. The United States, for example, has always granted U.S. citizens free convertibility of the dollar (except for a period of limited restriction from 1968-1974). *Id.*

Similar to China, most former communist Eastern European countries are changing their economies from the centrally planned model. These countries, like China, are now switching to market-oriented economies and are either seeking to make or have already made their currencies convertible. For individual country studies and a full discussion of the complex issues involved in attaining convertibility (especially with reference to Eastern Europe), see CURRENCY CONVERTIBILITY IN EASTERN EUROPE (John Williamson ed., Institute for International Economics 1991).

While some commentators regard currency convertibility as the capability of converting currency into real commodities, that is not the sense used in this Note. For a discussion of commodity-type convertibility, see PATRICK COLLINS, CURRENCY CONVERTIBILITY: THE RETURN TO SOUND MONEY (1985).

25. One commentator offers the following well-balanced explanation of what defines a centrally planned economy:

> The sharp distinction sometimes drawn between "planned" economies and "market" economies is, of course, false. Many of the so-called planned economies have significant non-planned sectors, such as agriculture in Poland. In the United States, on the other hand, agricultural markets are subject to significant government intervention. Nevertheless, there is a difference between an economy where a few state-owned institutions must do most of their buying and selling at market prices and an economy where a few non-state actors must operate in a world of fixed prices bearing little relation to supply and demand

Clarke, *supra* note 17, at 2 n.2.

26. In addition, the PRC is reported to have engaged in barter with several Third World countries. Triplett, *supra* note 16, at 201. One source describes barter as follows:

> Peking [Beijing] officials have indicated that this is their preferred form of settlement as it facilitates planning and is, by definition in balance. The usual pattern is the signing of a trade agreement by the People's Bank [of China] and the trading partner's State Bank, covering settlement and the goods to be exchanged.... The most important agreement with a non-communist country is the rubber-rice swap with Sri-Lanka.... China agreed to export 200,000 tons of rice annually, and Sri Lanka agreed to export 40,000-50,000 tons of rubber, depending on the world's price of rubber.

Id. (footnotes omitted). Another source describes countertrade as follows:

> When goods proposed for export to a NME [non-market, centrally-planned economy] are not of a sufficient priority according to state plan to merit government approval of payment in hard currency, or when the exporter is convinced by the

made settlements in the currency of the trading party with Third World countries.[27] In trade with other Western, capitalist countries before 1968, the People's Bank of China made arrangements with individual banks, usually in pounds sterling.[28]

When a sharp devaluation of that currency by the British government resulted in an immediate depreciation of all Chinese exports, the PRC switched to *renminbi* for later trade.[29] Certain Western banks were allowed to sell *renminbi*, provided the foreign trader had an underlying contract with a state owned trading organization.[30]

In light of these tight controls, the People's Bank of China played a passive role of servant to the central plan.[31] Foreign exchange receipts were essentially viewed as another, albeit special, commodity under the central plan.[32] Barter[33] and non-cash allocations[34] reduced the amount of cash and foreign exchange involved in trade.

B. Foreign Exchange Controls after the "Open Door" (1978-1993)

The open door policy initiated under Chairman Deng Xiao Ping in 1978 resulted in a new influx of trade and direct investment for China.[35] Unlike earlier agricultural reforms pioneered by Deng, these

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NME that such is the case, the NME may allow payment for the foreign imported goods only by the acceptance of local NME goods.

RALPH H. FOLSOM ET AL., INTERNATIONAL BUSINESS TRANSACTIONS IN A NUTSHELL 276 (1992). A list of the countries and their payment arrangements made with the PRC can be found in INTERNATIONAL MONETARY FUND, *supra* note 16, at 108.

27. Triplett, *supra* note 16, at 201.

28. *Id. See also* Sander Tideman, *Dealing with Nonconvertibility and Other Financial Aspects of Doing Business in China*, E. ASIAN EXECUTIVE REP., July 15, 1993, at 16, 17 ("It could be said that until 1968, there was no foreign exchange problem in China: all international trade was conducted in pounds sterling."), *available in* LEXIS, Asiapc library, Easian file.

29. Triplett, *supra* note 16, at 201; Tideman, *supra* note 28, at 17. After the devaluation, "an attempt was made to use the Swiss franc, but it has not been universally accepted." Triplett, *supra* note 16, at 201. *But cf.* INTERNATIONAL MONETARY FUND, *supra* note 16, at 108 (stating that the PRC used the Swiss franc to express trade transactions with a list of communist countries).

30. Triplett, *supra* note 16, at 202 ("The foreign bank is forbidden to sell RMB [*renminbi*] unless the merchant can show a signed contract with one of the PRC's state trading companies.").

31. Hongru, *supra* note 20, at 339.

32. *Id.*

33. *See supra* note 26.

34. Allocation conditions bank disbursements on the availability of physical goods that can be controlled in both production and price. Triplett, *supra* note 16, at 193.

35. The 'open door' economic policy of China was initiated in 1978, shortly after the death of Chairman Mao, as part of the ambitious 'Four Modernization' plan of the new

reforms were not unleashed on the whole of China, but only in certain selected areas for fear of capitalist influence on too grand a scale.[36] The influx of foreign direct investment was directed into Special Economic Zones and Economic and Technological Development Zones.[37] The investment created a need for new foreign exchange controls which would address two principal problems: the use of dual currencies and the difficulty of converting *renminbi* proceeds into foreign exchange.

1. *No Longer "The People's Money"— Foreign Exchange Certificates*

Starting in 1980, foreigners in the PRC were issued Foreign Exchange Certificates (FECs), a foreigners-only currency nominally equivalent to the *renminbi*, for their foreign exchange.[38] Other than this buffer currency, all foreign exchange was placed under tight restriction by the new State General Administration of Exchange Control (SGAEC), which was instructed to prohibit the circulation,

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leadership. FOREIGN TRADE, *supra* note 8, at 1. *See also* Cohen & Valentine, *supra* note 7, at 164 ("China's decision to accept FDI [foreign direct investment] was the result of a fundamental shift in political leadership and economic policy that began after the Cultural Revolution and that crystallized . . . in December 1978."). The four areas to be modernized were agriculture, industry, science and technology, and national defense. *Id.*

One commentator described the level of foreign trade expansion as follows:

> Since the adoption in late 1978 of an 'open-door policy' of welcoming foreign investment in and trade with China, China's foreign trade has grown rapidly. To date [1987], the People's republic of China has established trade relations with over 176 countries and regions and has signed trade agreements or protocols with some 94 countries. Moreover, in addition to become increasingly active in international trade matters under the auspices of various United Nations bodies, China established relations with the General Agreement on Tariffs and Trade (GATT) in 1980 . . . .

Horsley, *The Regulation of China's Foreign Trade, in* FOREIGN TRADE, *supra* note 8, at 7 (citations omitted). For more recent figures of China's trade see *supra* text accompanying note 4.

36. *The South China Miracle*, ECONOMIST, Oct. 5, 1991, at 19 ("Unlike the rural reforms, [the 'open door' policy] was applied selectively, so that China as a whole should not risk veering on to the 'capitalist road.'").

37. For a discussion of SEZs and ETDZs, see *supra* notes 9-10 and accompanying text.

38. The FEC notes, somewhat smaller than the equivalent *renminbi* denominations and inscribed in English, stated on their backs that the "yuan expressed in this certificate is equivalent in value to the Renminbi yuan." *See* Dinah Lee, *China Opens Door to a Black Market; Foreigners' Scrip Buys Luxury Goods*, WASH. POST, Feb. 5, 1985, at A12 ("The foreign scrip is issued in the same denominations as the regular Chinese currency, but in different colors and slightly different sizes."). The circulation of FECs began on April 1, 1980. INTERNATIONAL MONETARY FUND, *supra* note 16, at 111. It ended with the Foreign Exchange Reforms discussed *infra*.

pledging, or use of foreign currency in the PRC.[39] The SGAEC was also to prohibit unauthorized transactions and ensure that all foreign exchange buying and selling was conducted by the People's Bank of China.[40]

The government created this second currency to serve several objectives: curbing foreign currency speculation; preventing foreign merchandise from flooding the domestic market; and increasing the PRC's foreign exchange reserves.[41] The first objective was only weakly served by the regulations, as the speculators and black marketeers quickly embraced the FEC.[42] Neither was the currency exceptionally successful in furthering the second objective: the limitation prevented Chinese nationals from buying foreign merchandise only to the extent that FEC-only stores selling the imported merchandise, such as Friendship Stores, refused to accept the currency from them.[43] As for foreign exchange reserves, the creation of the FEC ensured that nationals would not directly drain government foreign exchange to finance imports outside of the state plan.[44] It did not, however, prevent nationals from indirectly depriving the government of foreign exchange via black market transactions.

The foreign exchange certificate created a hinderance to foreign direct investment mainly because the value of the two currencies differed. Although the Chinese government considered the FEC to be

39. The Provisional Regulations of the People's Republic of China Governing Foreign Exchange Control [hereinafter Foreign Exchange Control] (promulgated December 18, 1980) established the SGAEC in Article 3 and the enumerated prohibitions in Article 4. The English and Chinese texts of most of the regulations listed in this Note can be found in COMMERCIAL, BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA (Owen D. Nee, Jr. ed., 1991). Original texts and English translations of regulations mentioned in this piece promulgated before 1988 are also available in CHINA'S FOREIGN ECONOMIC LEGISLATION, VOL. I (Foreign Languages Press 1982); CHINA'S FOREIGN ECONOMIC LEGISLATION, VOL. II (Foreign Languages Press 1986); and CHINA'S FOREIGN ECONOMIC LEGISLATION, VOL. III (Foreign Languages Press 1987). Since the translations differ slightly in these sources, it is best to check the date on which the law was promulgated.

40. Foreign Exchange Control, *supra* note 39, arts. 3, 4.

41. Yates, *supra* note 21, at 838. *See also* Foreign Exchange Control, *supra* note 39, art. 1 (lists increasing foreign exchange reserves as a purpose of the regulations).

42. Yates, *supra* note 21, at 840 ("Apparently, in its meager attempt to control the growing black market, the Chinese government may have fueled a bigger market."). The black market is discussed *infra* Part II.C.3.

43. *Id.* (reporting that stores in Shanghai sold foreign goods to anyone presenting FEC).

44. *Id.* at 845.

"equivalent in value" to the *renminbi*,[45] the currencies' purchasing power in relation to imported goods resulted in a higher value for the FEC.[46] Because foreign funded enterprises and their expatriate employees had to pay for some domestic goods and most services[47] with the FEC, a de facto two-tier price system existed whenever the same price was offered to domestic enterprises that paid in *renminbi*.[48] In short, the creation of the FEC was a hidden form of discrimination against foreigners and foreign direct investment.[49]

2. *Foreign Direct Investment Proceeds Non-Convertible*

Another damper to foreign direct investment is the difficulty of converting *renminbi* into foreign currency for repatriation of profits[50] or for operational expenses.[51] Strict guardian of its foreign exchange reserves, the PRC has always encouraged all enterprises, including

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45. As stated on the back of an FEC certificate. *See* Lee, *supra* note 38, at A12 ("These certificates were introduced in the spring of 1980 as a special scrip for foreigners, and are officially valued at 1 to 1 for the regular Chinese currency.").

46. *China's Currency; Dead Certs*, ECONOMIST, Apr. 19, 1986, at 80 ("Although the renminbi and FEC have the same face value, the extra purchasing power of the certificates commanded a fat premium on the black markets."). Recognizing this absurdity, many foreigners have referred to the FEC as "funny money." *End of 'Funny Money'*, J. COM., Dec. 30, 1993, EP Sec. at 6A.

47. *See* Yates, *supra* note 21, at 838 ("FECs are required for the payment of *all* government services.") (emphasis added) (footnote omitted).

48. For example, if the black market offers 1.5 *renminbi* yuan for one FEC (as it did when the author visited the PRC in 1993), a cola costs 50 percent more in a friendship store than it would at a street market, where *renminbi* is commonly accepted.

The two-tiered rate system referred to in this Note is not to be confused with the two-tiered system established by the PRC's use of a lower exchange rate for certain "internal" transactions which ended in 1985. One commentator describes that system as follows:

> Between 1980 and 1984, China operated a dual exchange rate system, designed to discourage imports, encourage exports and maximize tourist revenues. The government fixed the exchange rate at Rmb2.8:US$1 for all domestic importing and exporting organizations. The Rmb rate applying to all foreign entities' transactions through the Bank of China, however, was set at a lower rate of Rmb1.5:US$1. Thanks to overseas pressure following allegations of protectionism, the two rates were unified in 1985 to a single rate of Rmb2.8:US$1.

Money and Banking—11.1: Currency: Renminbi, CHINA HAND, Oct. 1, 1993, at 5, *available in* LEXIS, Asiapc Library, China File [hereinafter CHINA HAND]. *See also* Lee, *supra* note 38, at A12.

49. Further forms of discrimination against foreign direct investment by the PRC are explored *infra* Part IV.A.

50. Cohen & Valentine, *supra* note 7, at 188-89; *Hard Currency Problem*, *supra* note 3, at 519-21.

51. *Hard Currency Problem*, *supra* note 3, at 519-20 (listing "the servicing of hard currency loans, import of equipment, parts or raw materials, and payment of expatriates' salaries and technology licensing fees" as operational expenses).

foreign funded enterprises, to concentrate on exports to earn needed foreign exchange (also known as "balancing" foreign exchange).[52] However, as the discussion below will show, the current view has shifted somewhat from the former Chinese position which considered balancing foreign exchange the sole responsibility of the enterprises.[53]

3. *Alternative Means of Obtaining Foreign Exchange*

Under the strict enforcement of PRC law, generating foreign exchange soon became a major problem for managers of foreign funded enterprises, especially in the production sector.[54] In certain cases, the foreign exchange problem became acute. The American Motors Corporation joint-venture in Beijing is one well-known example.[55] Because of a shortage of foreign exchange to pay for parts, production of the "Beijing Jeep" was completely halted in early 1986.[56] This and other experiences forced the PRC to reconsider the goals of the "open door" policy, which at the time were the generation of foreign exchange for backing domestic reforms,[57] and begin to welcome invest-

52. Cohen & Valentine, *supra* note 7, at 188-89; *Hard Currency Problem*, *supra* note 3, at 520-21.

53. Cohen & Valentine, *supra* note 7, at 189 ("In principle, each venture is thus supposed to balance its own foreign exchange account.").

54. *Hard Currency Problem*, *supra* note 3, at 521 ("According to Chinese government statistics, only one-third of the 4,000 foreign investment enterprises operating in China by the end of 1987 were able to balance their foreign exchange accounts.") (footnote omitted). *See* Mary Lee, *Foreign Investment: New Rules Help but it's a Struggle For Some*, FAR E. ECON. REV., Mar. 20, 1986, at 87-88 ("Mofert's [a central PRC trade body] deputy director of foreign investment . . . maintains that approximately *half* the joint ventures in the production sector . . . have foreign exchange 'difficulties'.") (emphasis added).

It must be emphasized that not all ventures had difficulty generating foreign exchange. Cohen & Valentine, *supra* note 7, at 188 ("Those ventures established with FDI that are export-oriented or provide services to foreign tourists are able directly to earn foreign exchange and have been the most successful in avoiding serious foreign exchange deficits."). However, production-oriented joint ventures not only provide an influx of Western capital and utilize Chinese labor, but they also infuse Chinese factories with important new technology.

55. Doron P. Levin, *AMC, China Agree on 2-Month Halt of Jeep Production*, WALL ST. J., May 23, 1986, at 25. For examples of other joint ventures with foreign exchange problems, see Julia Leung, *Westerners' Joint Ventures in China Encounter Bureaucratic Delays, Foreign-Exchange Blocks*, WALL ST. J., Mar. 18, 1985, at 38.

56. Levin, *supra* note 55, at 25. Production resumed several months later, after China relaxed its currency controls in return for promises from AMC to scale down production on Jeeps made from imported parts. *China Notes: Jeep Production is Resumed in Peking*, WALL ST. J., Aug. 28, 1986, at 18.

For a more detailed account of the early history of the AMC-Beijing Jeep joint venture see JIM MANN, BEIJING JEEP: HOW WESTERN BUSINESS STALLED IN CHINA (1989).

57. *Sino Xenophilia*, *supra* note 23, at 14. Two other commentators also noted that for many years the PRC remained satisfied with the special interest of investors generally

ment that brought in other kinds of benefits, like the transfer of new and more efficient technology.[58] To codify China's new view, regulations were promulgated in 1986 and 1987 to provide several methods, other than export, of obtaining foreign exchange.[59]

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outside the industrial sector. Cohen & Valentine, *supra* note 7, at 194. They have classified these investors into three types, noting how they account for a prodigious share of the foreign direct investment in China:

> Hong Kong investors, who, as we have seen, *accounted for most major FDI [Foreign Direct Investment] from 1979 to 1985*..., are well situated to take advantage of small "windows of advantage," especially in the adjacent Shenzhen SEZ and in Guangdong Province generally. For example, they can utilize PRC quotas for textile exports to the United States or provide services to foreign tourists or business people. Familial ties or concern for the implications of Hong Kong's reunion with the PRC in 1997 have also provided strong incentives for some wealthy compatriots to demonstrate their loyalties by investing in China.
>
> Oil companies have also been largely motivated by factors that minimize the effect of high costs. As we have seen, ... as of 1985, *over 60% of the total FDI pledged by American, Western European and Japanese companies had been for offshore oil development.* These companies came to the PRC for essentially strategic reasons—the effects of the so-called "oil shocks" of the 1970's had vividly demonstrated the need to diversify sources of oil—and the PRC represented one of the last untapped frontiers.
>
> The story is similar with respect to a third type of investor, one committed to development of China's tourist facilities. We have seen that until 1986, *the majority of FDI was pledged to non-productive enterprises including hotels, other tourist projects, taxi companies and other service industries* ....

Id. at 194 n.120 (emphasis added) (internal cross-references omitted).

58. As in the Beijing Jeep case noted above. *See* Leung, *supra* note 55, at 38 (Shanghai official finds the number of industrial projects unsatisfactory as over 60% of investment pledged for Shanghai was either for hotel or office construction).

59. There are six regulations which relate to the establishment of alternatives for ventures not concentrating on exports: (1) Regulations of the State Council Concerning the Issue of Balancing Foreign Exchange Receipts and Disbursements by Joint Ventures Using Chinese and Foreign Investment (promulgated Jan. 16, 1986) [hereinafter Joint Venture Balancing Provisions]; (2) Provisions of the State Council Regulations Concerning Encouragement of Foreign Investment (promulgated October 11, 1986) [hereinafter 22 Articles]; (3) Measures of the Ministry of Foreign Economic Relations and Trade for Enterprises with Foreign Investment to Solve the Balance of Foreign Exchange Receipts and Expenditures by Purchasing Domestic Products for Export (promulgated Jan. 20, 1987, regulation expanded the benefits of the Joint Venture Balancing Provisions and added wholly foreign-owned enterprises) [hereinafter Measures for the Purchase and Export of Domestic Products]; (4) Trial Procedures Concerning the Use of Products for Import Substitution (promulgated by the Guangdong Provincial People's Government, Dec. 8, 1986); (5) Measures Concerning Import Substitution for the Products of Chinese-Foreign Equity and Cooperative Joint Ventures (issued Oct. 19, 1987); (6) Measures for the Administration of Import Substitution for the Mechanical and Electrical Products of Chinese-Foreign Equity and Cooperative Joint Ventures (issued in Oct. 1987), *available in* COMMERCIAL, BUSINESS AND TRADE LAWS, *supra* note 39.

The list of methods which follows is by no means authoritative and is presented for the purpose of providing an overview. For a more complete discussion of both national and regional options for investors with foreign exchange difficulties, see *Hard Currency Prob-*

a. Swap Markets

Probably the most successful of the PRC's efforts,[60] the swap markets allow firms to balance their foreign exchange by trading *renminbi* for foreign exchange with other firms that have a surplus. The swap markets arose from the system of hard currency retention established under early 'open door' reforms.[61] The retention quotas, given in the form of certificates to domestic enterprises that generated a foreign exchange surplus, allowed for a later purchase of foreign exchange.[62] A small market soon developed for unused retention quotas among domestic firms who bought them with *renminbi*.[63] Eventually, this practice was extended to foreign funded firms to allow for "adjustment" of foreign exchange imbalances in joint ventures owned by the same foreign investor[64] (e.g. a foreign exchange-rich hotel and a Jeep factory serving the Chinese market).[65] Later, all foreign

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lem, *supra* note 3. For a recent discussion of how foreign funded enterprises are dealing with the foreign exchange problem, see John Frisbie & Richard Brecher, *A Tough Balancing Act*, CHINA BUS. REV., Nov./Dec. 1993, at 9-13.

60. A survey published in 1993 indicates that the swap markets are the leading method for obtaining foreign exchange. Frisbie & Brecher, *supra* note 59, at 11-12 (close to three-quarters of foreign invested enterprises reported using the swap markets which provided 55% of their foreign exchange needs, 14 firms reporting 70%).

61. Tideman, *supra* note 28, at 17. One commentator offers the following explanation of retention quotas:

> Countries with a foreign-currency surrender requirement sometimes also establish "retention quotas." That is, exporters from the state are allowed to keep and not surrender a portion of certain foreign currencies received. In some cases, this may simply avoid the administrative costs associated with collecting exchange and then providing it back to the firm for approved expenditures.... The firm may find it difficult to otherwise obtain that foreign currency for use in paying for imports that may not have a high governmental priority.

RICHARD W. EDWARDS, INTERNATIONAL MONETARY COLLABORATION 386 (1985).

62. Tideman, *supra* note 28, at 17.

63. *Id.*

64. Joint Venture Balancing Provisions, *supra* note 59; *Hard Currency Problem*, *supra* note 3, at 522.

65. Although they were not owned by the same investor, ITT-owned Great Wall Sheraton Hotel in Beijing provided AMC's Beijing Jeep Corporation with over $2.5 million in one of the earliest publicized foreign firm swaps. James R. Schiffman, *Chinese Regulations Seek to Mollify Investors*, WALL ST. J., Dec. 24, 1986, sec. 2, at 12 (referring to swapping as an "informal practice").

The Proctor & Gamble joint venture offers a more accurate example:

> [Proctor & Gamble] operates a shampoo joint venture in Guangzhou that exports roughly 30% of its products. Hard currency earned from those exports isn't enough to satisfy the venture's requirements. The shortfall is made up by export sales of chemicals and towels from China by Hutchison Whampoa Ltd., a Hong Kong company that has a stake in [Proctor & Gamble's] shampoo factory.

Julia Leung, *Change for a Dollar*, WALL ST. J., Dec. 10, 1993, at R8.

invested enterprises were granted entry into the former retention quota market,[66] which became known as the swap markets.

The swap market is governed by the State General Administration of Exchange Control (SGAEC)[67] and its various sub-bureaus, and transactions take place in Foreign Exchange Transaction Centers (FETCs, also referred to as "swap markets"). FETCs are located in major cities and accommodate the multitude of enterprises with foreign exchange needs.[68] In 1992, a national swap market was established in Beijing to better unify prices at swap centers across the country.[69] However, regional protectionist policies prevented cross-border swapping[70] and thus kept exchange rates higher in certain outlying exchange centers away from China's economic zones when demand has outpaced supply.[71]

In practice, the bids between FETC brokers (which included certain foreign banks in China) and principals (including joint ventures) must be submitted to government clerks who match them and determine their legality.[72] Generally, most of the matching actually goes on outside the market as sellers (or their brokers) find buyers and then test rates with SGAEC officials.[73] Buyers and sellers exchange checks or use remittances (not cash) and the SGAEC receives a commission on the completed transaction.[74] FETC trading volumes increased to over $25 billion in 1992,[75] with the Shanghai center reporting a daily turnaround of nearly $30 million in 1993.[76] Foreign invested enter-

66. 22 Articles, *supra* note 59; *Hard Currency Problem*, *supra* note 3, at 522.

67. Also discussed *supra* note 39.

68. *Hard Currency Problem*, *supra* note 3, at 523.

69. *China's Currency Swap Market*, WALL ST. J., Aug. 10, 1992.

70. Virginia Davis & Carlos Yi, *Balancing Foreign Exchange*, CHINA BUS. REV., Mar./Apr. 1992, at 14, 18 (explaining that while one swap center can legally apply to another city's swap center to swap currency, "approval of individual applications is up to local authorities"). *See also* Frisbie & Brecher, *supra* note 59, at 11.

71. *Id.* at 12 ("the swap rates themselves often move according to currency supply and demand in the individual swap centers.").

72. Peter Hannemann, *China: Big Spread in the Currency Exchange Rates*, AUSTL. FIN. REV., June 23, 1993, at 33, *available in* LEXIS, Asiapc Library, Allasi File.

73. Although some of the local branches of the SGAEC have officially disallowed this practice in certain regions, it seems to be prevalent all over China. *See* Davis & Yi, *supra* note 70, at 18 (stating Guangzhou allows prearranged exchanges but Shanghai and Shenzhen require brokers). *See also* Julia Leung, *Beijing Hopes its Currency Experiment Will Help it Escape Monetary Dilemma*, WALL ST. J., Aug. 29, 1988, at 6 (noting a phone call to the SGAEC made as part of a swap market transaction by a Shanghai Hilton Hotel accountant to test the rates).

74. Davis & Yi, *supra* note 70, at 18 (noting an average commission of .15%).

75. Tideman, *supra* note 28, at 117.

76. Hannemann, *supra* note 72, at 32.

prise trading volume in the swap market has also increased dramatically.[77]

b. *Import Substitution*

Although the idea of localizing production to avoid dependence on foreign sources existed since the founding of the PRC,[78] the legal basis for selling domestic products in China for foreign exchange actually originated in 1983,[79] and was further explained by legislation from 1986 onward.[80] Import substitution applies only to products manufactured by foreign invested enterprises that China needs to import.[81] These products can be sold to domestic firms for foreign exchange with the approval of the Chinese foreign trade agency with appropriate jurisdiction.[82] Although import substitution has attracted foreign direct investment in certain areas because it presents a means of access to the China's domestic markets,[83] the reported success in utilizing import substitution to solve foreign exchange problems has been minimal.[84] Furthermore, the Chinese government has since promised

77. Davis & Yi, *supra* note 70, at 16 (includes graph).

78. *Hard Currency Problem*, *supra* note 3, at 521 n.7.

79. Rules for the Implementation of Exchange Controls Relating to Overseas Chinese Enterprises, Foreign Enterprise and Chinese-Foreign Equity Joint Ventures (promulgated Aug. 1, 1983), *available in* COMMERCIAL, BUSINESS AND TRADE LAWS, *supra* note 39.

80. *See* laws cited *supra* note 59 (Joint Venture Balancing Provisions; Trial Procedures Concerning the Use of Products for Import Substitution; Measures Concerning Import Substitution for the Products of Chinese-Foreign Equity and Cooperative Joint Ventures; Measures for the Administration of Import Substitution for the Mechanical and Electrical Products of Chinese-Foreign Equity and Cooperative Joint Ventures). For a more detailed discussion of import substitution, see *Hard Currency Problem*, *supra* note 3, at 531-42.

81. Rules for the Implementation of Exchange Controls Relating to Overseas Chinese Enterprises, Foreign Enterprise and Chinese-Foreign Equity Joint Ventures, *supra* note 79, art. 12.

82. *Hard Currency Problem*, *supra* note 3, at 533.

83. Joseph Battat, *Foreign Investments in China In The 90s: Developing Trends*, E. ASIAN EXECUTIVE REP., Aug. 15, 1991, at 11, 14 ("Import substitution has become another major reason for FDI in a variety of sectors, including electronics, computers, machinery, beverages, packaging and chemicals. These projects have been lured by the size of the highly protected domestic market.").

84. Frisbie & Brecher, *supra* note 59, at 11 (authors of survey on foreign funded enterprises in China report that import substitution "should *not* be viewed as a viable method of balancing foreign exchange. In the survey only a single company indicated it is able to get a government department or other Chinese entity to convert RMB earned through domestic sales into foreign exchange, and these transactions meet only 10 percent of the venture's total foreign exchange needs.").

to eliminate import substitution policies in a market access memorandum of understanding with the United States.[85]

c. Flexible Pricing

Certain regions have allowed foreign funded firms to balance their foreign exchange through domestic sales of foreign exchange (or of a mix of foreign exchange and *renminbi*) in a process known as "flexible pricing." [86] Flexible pricing is separate from the national laws promulgated in 1986-87 and exists on an ad hoc basis but is worth mention because of its usefulness in balancing foreign exchange.[87] Flexible pricing worked because prior to the Foreign Exchange Reforms many Chinese state-owned enterprises were allowed to keep a portion of their foreign exchange income,[88] giving them enough largesse to make these purchases with some of this hard currency. Paying with foreign exchange often allowed them to purchase products they might have had to pay for exclusively in foreign exchange as imports, or obtain priority with suppliers.[89] Many foreign funded firms reported success with flexible pricing.[90]

d. Export of Domestically Purchased Products

Established with the Joint Venture Balancing Provisions and the Measures for Purchase and Export of Domestic Products,[91] this method allows foreign funded firms with foreign exchange difficulties

85. Henrik Hansen, *China Agrees to Increase Market Access for U.S. Exports*, E. Asian Executive Rep., Oct. 15, 1992, at 16. *But see Investment-Related Restrictions Based on Industrial Policy Draw Criticism from the U.S.*, E. Asian Executive Rep., May 15, 1994, at 12 ("While import substitution lists may no longer be circulated, the report [from U.S officials in Beijing] states that both the capital budgeting process and the foreign exchange system are biased in favor of local products in that they tend to make buyers exhaust all local procurement possibilities before imports are approved.").

86. *Hard Currency Problem*, *supra* note 3, at 530.

87. *Id.*

88. Davis & Yi, *supra* note 70, at 16 ("Retention rates were last modified in January 1991, leaving anywhere from 40 to 70 percent of foreign exchange earned from exports at the local level."). For a discussion of the retention system, see *supra* note 61 and accompanying text.

89. *Hard Currency Problem*, *supra* note 3, at 530.

90. Frisbie & Brecher, *supra* note 59, at 11:

> In our sample, domestic sales for hard currency are relatively common (34 percent), and for firms that use it, this balancing method accounts for a substantial share of their foreign exchange needs (average of 42 percent). Fifteen percent of the sample derive at least half of the foreign exchange they require via this method.

But cf. Interview, *infra* note 167 (describing the practice as not widespread).

91. *Supra* note 59.

to purchase and export Chinese products for foreign exchange.[92] While the procedure is subject to many bureaucratic and practical limitations,[93] some investors have used it successfully.[94]

e. Reinvestment of Renminbi Profits in a Another Enterprise

The Joint Venture Balancing Provisions[95] also allowed foreign joint ventures to invest renminbi profits in domestic Chinese firms and cull the resulting foreign exchange earnings.[96] Of the methods for obtaining foreign exchange presented herein, this method seems the most doubtful.[97]

4. Some Preliminary Conclusions

Despite the implementation of the above methods, obtaining foreign exchange still remains a major problem for non-export oriented foreign funded enterprises.[98] Of the solutions, the swap markets (which have recently been reported to be relatively permissive in allowing access to foreign exchange)[99] and the export of domestically

92. For a more detailed discussion of this procedure, see *Hard Currency Problem*, *supra* note 3, at 524-26.

93. Such as finding a domestic firm willing to sacrifice sales that would otherwise net precious foreign exchange; getting official approval on an annual basis; getting provincial approval when the product sought to be sourced under the wings of another province's trade body, etc. *Id.* at 525-26.

94. *Id.* at 525.

95. *Supra* note 59.

96. For a more detailed discussion of this procedure, see *Hard Currency Problem*, *supra* note 3, at 526-27.

97. Two commentators write:

> [T]his method is not very attractive to foreign investors, who may, understandably, be quite reluctant to commit further investment funds in China when they are still unable to realize a return in foreign exchange on funds already invested. Nor is the method attractive to Chinese enterprises, because they will have to pay out foreign exchange to the foreign investor in return for a renminbi investment. Unless foreign investors are prepared to make such reinvestment arrangements more attractive to a Chinese enterprise—for example, by also investing foreign exchange in it, by providing it with advanced technology, or by offering the Chinese enterprise a new export channel—they are unlikely to arouse interest.

Id. at 527.

98. In a 1989 survey, 54 percent of Sino-American joint venture owners responding reported foreign exchange shortages. Cecilia L. Wagner, *A Survey Of Sino-American Joint Ventures: Problems And Outlook For Solutions*, E. ASIAN EXECUTIVE REP., Mar. 15, 1990, at 9. The problem ranked third in severity amongst the problems in the survey. *Id.* at 9-10.

99. Joseph Kahn, *China's New Currency Exchange Center May Create Havoc for Foreign Concerns*, WALL ST. J., Feb. 24, 1994, at A12 ("But many companies have found the existing swap market system relatively flexible in practice, allowing them to trade Chinese currency for foreign exchange well before they meet targets for earning hard currency through exports.").

purchased products seem to have been most successful.[100] Conclusions on the expected impact of the current reforms on this issue are presented below.[101]

C. *The Confusion Before Reform: Three Exchange Rates*

In addition to non-convertibility and the exchange constrictions of the FEC discussed above, multiple exchange rates, with a total of three foreign exchange rates and accompanying markets,[102] caused further difficulties. Puzzled investors had to choose either the official rate, the swap rate, or the black market rate.[103]

1. *The Official Rate*

The official value of the *renminbi* (and FEC)[104] was determined by the government under a system mixing market guidance and government intervention (a so called "managed float"), with the SGAEC setting rates daily.[105] One way market forces entered the calculation was through a weighted combination of currencies, which have remained unspecified, but probably included the United States and Hong Kong dollars and the Japanese yen.[106] The official exchange rate rose from a symbolic one to one par with the U.S. dollar at the founding of the PRC, to a low of roughly 5.7 shortly before the current reform, largely as a result of official devaluations.[107]

This rate was used exclusively by the Bank of China and its subsidiaries until 1993, when a rate slightly below the swap rate began to be offered to Chinese nationals and their businesses with proper documentation at some of these banks.[108] Foreign direct investments (contributions of capital, equipment, and technology), however, were

100. Wagner, *supra* note 98, at 9. Frisbie & Brecher, *supra* note 59, at 11.
101. *See infra* part IV.
102. Sender, *supra* note 11, at 64-65; Leung, *supra* note 65, at R8.
103. Sender, *supra* note 11, at 64-65; Leung, *supra* note 65, at R8.
104. Which was considered by the Chinese government to be equal to the *renminbi*, despite the former's higher purchasing power. *See supra* part II.B.1.
105. CHINA HAND, *supra* note 48, at 4.
106. *Id.* at 4-5 (although the currencies are unspecified, "these three represent the currencies of China's three largest trading partners."). *Cf.* INTERNATIONAL MONETARY FUND, *supra* note 16, at 107 (official rate calculation based on a "basket of internationally traded currencies, weighted with reference to their importance in China's external transactions and trends in their relative values").
107. Tideman, *supra* note 28, at 17.
108. CHINA HAND, *supra* note 48, at 3. Foreigners still obtained FEC when converting foreign exchange at the official rate.

always registered at the official rate.[109] Even with swap markets, certain trade transactions under state plan also used this rate.[110] This practice granted certain state owned firms an edge (compared to private firms and foreign funded enterprises forced to use the swap market) because they could obtain necessary raw materials and imports at a lower cost.[111]

2. *The Swap Rate*

Because, as illustrated in the discussion above, the swap markets are sanctioned by the PRC, one may consider the swap rate another "official" rate. But unlike the stable official rate, swap rates vary as swap markets in different geographical areas operate under varying local rules and market conditions (supply and demand).[112] As mentioned earlier,[113] China established a national center to help unify these rates. The swap rates remained higher than the official rate by a narrow margin for several years,[114] until the hard currency crisis discussed in Part III dramatically widened the gap.

3. *The Black Market Rate*

Until recently, black market currency exchanges remained small in nature, relegated to curbside transactions with foreign nationals

109. Sender, *supra* note 11, at 65 (also noting that foreign firms can compensate for the overvalued *renminbi* when calculating the value of equipment and technology; negotiations over exchange rates can be "deal-breakers"). *See also* Lincoln Kaye, *Discipline Restored*, FAR E. ECON. REV., Sept. 9, 1993, at 58 (explaining an equity evaluation process where Chinese and foreign contributions are given U.S. dollar equivalents and then under and over estimated respectively to reflect U.S. dollar terms).

110. Kate Yu Juan, *China's Currency Reform Vital but Some Tough Problems Remain*, STRAITS TIMES, Jan. 6, 1994, Comment and Analysis, at 26, *available in* LEXIS, News Library, Strait File.

111. *Id.* ("The old system was also a form of subsidy for state-owned companies, which were allowed to buy hard currencies at the official rate and then to rely on the unrealistic rate to buy raw materials at cheap prices."). For further discussion of this issue, in light of the new reforms, see *infra* part III.B.2.b.

112. Economist Intelligence Unit, *Money And Banking: 11.2 China's Foreign Exchange Adjustment Centres*, CHINA HAND, Oct. 1, 1993, at 8-10, *available in* LEXIS, Asiapc Library, China File.

113. See *supra* note 69 and accompanying text.

114. Cohen & Valentine, *supra* note 7, at 191 (reporting a one yuan margin in 1985). The gulf widened before the Tiananmen crisis in 1989 with increasing demand for consumer durables, but quickly narrowed with the following austerity program and two official rate devaluations. Davis & Yi, *supra* note 70, at 16 (graph); *see also id.* at 18 (noting that swapping became easier because the swap rates were so close to the official rate). The rift, however, has again widened since 1992. Sender, *supra* note 11, at 65 (includes graph showing the "widening gulf").

working or traveling in China.[115] Similar to the swap market, the rates in these transactions were set by supply and demand, on a more localized scale.[116] However, increases in foreign exchange demand led to an increase in the size of black market trades, as some firms began bypassing the swap markets altogether.[117] The black market developed its own "market makers."[118]

III. Crisis and Change

Understanding the effects of the Foreign Exchange Reforms on foreign direct investment necessitates an understanding of the role of the reforms in regaining control over China's economy. As the discussion below will illustrate, the reform of the foreign exchange system is an effort to regain central government control over the spending of state enterprises and provincial governments as well as stem capital flight.

A. *The Crisis*

1. *Foreign Exchange Outflows and Capital Flight*

Despite the PRC's need for capital for production-intensive ventures and investment in infrastructure, large amounts of foreign exchange have flowed out of the country both legally and illegally. In addition, the value of the PRC's currency has been endangered because of a lack of control over the financial system.

a. *Legal Capital Outflows*

As for China's legal overseas investment, levels have soared in recent years.[119] Large PRC transnational corporations invest in legiti-

115. Yates, *supra* note 21, at 843 ("[A]mong foreigners young tourists are the main contributors of foreign exchange and FECs.").

116. *Id.* (noting higher rates when tourism is down).

117. Elizabeth Cheng, *Arbitrage in China*, FAR E. ECON. REV., May 21, 1992, at 44 (describing how currency couriers travel to a foreign exchange rich Special Economic Zone from "currency hungry" areas of China carrying average amounts equivalent to US $183,500 for trade on the black market).

118. Kaye, *supra* note 109, at 58 (defining market makers as "wholesale traders who specialize in matching large-scale buy-and-sell orders").

119. Friedrich Wu, *Stepping Out the Door: Chinese Investments Abroad*, CHINA BUS. REV., Nov./Dec. 1993, at 14, 18. According to the International Monetary Fund, cumulative Chinese investment abroad has risen from just under one billion in 1985 to 5.5 billion in 1991, based on statistics provided by the Bank of China, the supplier of foreign exchange in the PRC. *Id.* *See also* E.S. Browning, *High Rollers*, WALL ST. J., July 21, 1994, at A1 ("No one has complete figures, but U.S. Commerce Department data on large foreign

mate ventures officially "aimed" at raising foreign exchange income, bypassing host-country trade barriers, entering new markets, gaining advanced technology and modern management skills, and obtaining reliable supplies of important natural resources.[120] However, a weak track record for many projects invites the suspicion that the actual motivation might be to move capital outside of China.[121]

b. Capital Flight

Although levels of illegal investment and capital flight are difficult to detect and quantify because, by definition, they are concealed, economists believe that billions of dollars are exiting the country illegally.[122] Many suspect that a good portion of these funds, once transferred offshore, come back into the PRC disguised as foreign direct investment in order to enjoy the tax and other benefits accorded by the Joint Venture Laws, Special Economic Zones, and Economic and

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investments showed just $26 million in Chinese assets here in 1985; by 1991, the latest year for which the department has figures, China's assets had nearly hit $1 billion.").

120. Wu, *supra* note 119, at 15. The goals listed above are the requirements established by China's Ministry of Foreign Trade (MOFERT) for approving Chinese funded non-trade joint ventures abroad.

However legitimate the purposes, some of the investment moves by these firms have resulted in huge losses. For example:

> China International Trust & Investment Corp. (Citic), the government's premier international investment arm, has lost millions of dollars on a decrepit Delaware steel mill and a worthless Colorado gold mine.
>
> One of the Foreign Trade Ministry's biggest business units, China National Metals & Minerals Import & Export Corp. (known as Minmetals), has made profits importing and exporting in the U.S. But it has wiped out that profit every year since 1990 by speculating in U.S. real estate.
>
> China's biggest construction group, China State Construction & Engineering Co., has been losing money here since 1986, investing in more than 20 projects nationwide, including a string of Georgia retirement homes that U.S. advisers urged it to avoid.

Browning, *supra* note 119, at A1.

121. *See id.* at A12 ("In some cases, Chinese company officials are so eager to get money out of the country and into a safe place that profits are a secondary issue.").

122. *China's Footloose Capital*, WALL ST. J., Mar. 8, 1994, at A16:

> Economist Friedrich Wu has examined "errors and omissions" in China's balance of payments, and finds evidence of $8 billion disappearing in 1992. Frank Gunter of Lehigh University has compared China's trade statistics with those of its major trading partners. He suspects enough money leaks out through phony import and export invoices to bring the total to roughly $20 billion a year.

See also Lincoln Kaye, *This Money Has Wings*, FAR E. ECON. REV., July 15, 1993, at 72 (details of Gunter study); Harry Sender, *Follow the Money: China Faces Big Challenge in Controlling Capital Flows*, FAR E. ECON. REV., Oct. 14, 1993, at 74 (Another commentator, also basing estimation on deficits in China's "errors and omissions category," reports that capital flight "more than doubled between the first and second half of 1992 . . . .").

Technological Development Zones (discussed *supra* part II).[123] According to one commentator, many sham "foreign" joint ventures were established to evade high tariffs on the import of foreign cars.[124] Other outflows are suspected to float into personal bank accounts and real estate abroad.[125]

c. Lack of Control over the Financial System

Exacerbating the problem is the PRC's lack of control over its financial system. Although substantially restructured since the centrally-planned model described above,[126] the banking system is prey to pressures from both the central government bureaucracy above (to lend to loss-making state owned enterprises) and China's regions be-

123. Brauchli, *supra* note 6, at A12. *Cf.* Anthony H. Adams, *Hong Kong's Charms*, CHINA BUS. REV., Nov./Dec. 1993, at 19 (reporting estimates that 80 percent of the "Hong Kong" foreign investors in China are actually Hong Kong subsidiaries of mainland firms or "fake foreign investments"). For a discussion of the foreign investment benefits offered in SEZs and ETDZs see text accompanying and sources cited *supra* notes 9-10.

124. Brauchli, *supra* note 6, at A12:

> Many companies were set up by Chinese investors through overseas subsidiaries to take advantage of preferential tax treatment for foreigners or to exploit duty exemptions for foreign ventures that import autos. Because China's auto import duties can triple the price of a luxury car, many Chinese entrepreneurs establish false foreign companies for the sole purpose of importing, for example, a Mercedes-Benz or a Cadillac.

125. One reporter offers the following examples of questionable capital flows:

> [M]any who do business with the Chinese have concluded that some investors are primarily concerned with stashing cash abroad.
>
> When China Travel Service, a government-linked travel agency, spent $100 million to build a theme park named Florida Splendid China, which opened in Orlando in December, the local business community buzzed with talk that the real goal might be to move money out of China. . . .
>
> Americans who monitor activities of the People's Liberation Army, which is flush with dollars from gun exports to the U.S., say some Chinese military officials are quietly buying U.S. companies and real estate. . . .
>
> Other Chinese investors "have siphoned money off from deals they did with the Chinese government," charges Frederick Blumer, an Atlanta lawyer who has helped Chinese businessmen obtain visas. "You see them driving around in big Mercedes, wearing flashy clothes, going to the strip clubs."

Browning, *supra* note 119, at A1. *See also* Hornik, *infra* note 132, at 34 (noting how "double invoicing" is rampant in the PRC: local authorities or firms buy equipment at one price but are invoiced at a higher price, the difference is deposited in a foreign bank account).

126. *See* Hongru, *supra* note 20, at 334-40. For an overview of the PRC's banking system see Franklin D. Chu, *Banking and Finance in the China Trade*, *in* FOREIGN TRADE, *supra* note 8, at 343-79.

low (to lend to quick-buck ventures).[127] Recent World Bank estimates note that of all state bank loans, only thirty percent were based on commercial standards, the remaining seventy percent were "policy based" (i.e. loss-making).[128] Although the central bank sends notices to branches that exceed their lending targets, they are repeatedly ignored.[129] Furthermore, thirty percent of China's financial system is estimated to be unofficial and unregulated as banks interlend and then onlend to property development projects that promise quicker profits than the loans to official state enterprises.[130] As a result, China has been forced to print new *renminbi* to cover the money lost to risky ventures, increasing the money supply by alarming proportions.[131]

2. *Regionalism*

The decentralization of decision-making, initiated with Deng's "open door" policy, gained full speed with Chairman Deng's 1992 blessings. Wealthy regions with hard currency from foreign investment ignored commands from Beijing.[132] Once given permission to

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127. Harry Sender, *Finance: Out of the Wilderness*, FAR E. ECON. REV., Jan. 14, 1993, at 40; *see also* James Walsh, *China: Turning Down the Voltage*, TIME (Int'l ed.), Aug. 16, 1993, at 14.

128. Sender, *supra* note 127, at 41. Financial analysts note that many of the state run enterprises borrow at attractive rates and then lend the money to private enterprises at "at least twice" these rates in unregulated transactions. Carl Goldstein, *Policies: Beijing Tries Again to Cool China's Economy*, FAR E. ECON. REV., Feb. 17, 1994, at 44.

129. Sender, *supra* note 127, at 43.

130. *Id.* at 38 (also noting that "[e]ach part of the state bank system has its underside consisting of wholly owned non-bank financial institutions (NBFI) which account for much of the runaway investment"—the lending supports "quick-buck projects such as nightclubs, villas, racetracks and hotels" instead of basic infrastructure projects like roads).

131. Harry Sender, *Cooling Down Growth*, FAR E. ECON. REV., Sept. 2, 1994, at 36, 37 (quoting World Bank estimates of a 31.3% increase in the money supply in 1992, and a 50% increase in the first quarter of 1993; World Bank graph illustrates a tripling of the money supply since 1986).

132. Carl Goldstein, *South China: Resisting the Centre*, FAR E. ECON. REV., Sept. 2, 1993, at 42.

This central regional tension is nothing new to the PRC (although the economic gains in the provinces in recent years have exacerbated the problem). One commentator argues that decentralization and recentralization is a recurring motif in the Chinese economy:

> The literature on Chinese political organization generally contains two contrasting images. One is that of the omnipotent center. The country is effectively organized and led from the top, where leaders have the power to ensure compliance from lower levels on most issues at any time. The second image is that of a bickering, fragmented polity. Sub-central levels of the system have a great deal of power in practice and are willing and able to thwart and subvert the demands of the center . . . .
>
> Even before the commencement of the reform program, the Chinese economy was in many ways highly decentralized. Several waves of decentralization

attract foreign investment, many regions gained financial independence from the central government.[133] When the center tried to regain its control, the regions resisted, using foreign exchange for leverage. For example, when the central government refused to provide extra oil to Guangdong province, the most prosperous SEZ, Guangdong bought its own oil on the international market.[134]

Meanwhile, as certain (especially coastal) regions of China profited, others (generally in the interior) suffered. Regional protection policies hampered the flow of goods and capital.[135] Several regions were reported to have established their own "de facto" currencies to prevent the flow of goods.[136] Peasants, frustrated with the prospect of being paid in IOUs for their crops by cashless provincial governments,[137] began to migrate to the industrial centers for real wages, cluttering the train stations with their camps.[138]

3. *The Hard Currency Crisis*

The impact of the above forces on China's foreign exchange system was tremendous and unprecedented. The swap rate fell far below

> had drastically reduced the power of central planners in favor of local governments and quasi-governmental management bodies. Each time, the failure to pay attention to incentives facing local levels led to a lack of coordination and chaos, resulting in a recentralization. This recentralization, however, was never complete. Planning balances are extremely rough, leaving the working out of details to sub-central bodies, and the central government has never regained the financial control it lost during the Cultural Revolution.

Clarke, *supra* note 17, at 13-14. For a bearish overview of the current economic and political climate of China, including many of the issues discussed in this section, see two essays recently published under the overall title "China: The Muddle Kingdom." Richard Hornik, *Bursting China's Bubble*, FOREIGN AFF., May/June 1994, at 28; Gerald Segal, *China's Changing Shape*, FOREIGN AFF., May/June 1994, at 43.

133. Certain provinces now contribute a far larger proportion of taxes to the center than centrally allocated receipts. Goldstein, *supra* note 132, at 42, 44 (Guangdong province received 80 percent of its investment funds from Beijing in 1979, only two percent in 1992, and is now providing 27 percent of provincial revenues to the central government). *See also* Clarke, *supra* note 17, at 15 ("The more funds local governments have under their own control, the less they need to listen to Beijing."). The attitude of the provinces is illustrated by the following: "Asked how much control Beijing had over Guangdong's economic plans, the Chinese official [vice-governor of Guangdong] replied simply: 'None whatsoever.'" Goldstein, *supra* note 128, at 44.

134. Segal, *supra* note 132, at 46.

135. *Id.*

136. *Id.*

137. Walsh, *supra* note 127, at 17.

138. Hornik, *supra* note 132, at 37 ("The net result of the capital shortage is a shortage of jobs and opportunities [in central provinces] .... By one government estimate, China's 'floating' population of migrant workers is well over 50 million.").

the official rate as demand for foreign exchange escalated.[139] In mid-1993, concerns over the swap rate's free fall inspired a government cap on swap rates,[140] which in turn spurred businesses into the black market, with foreign invested firms sending out employees armed with mobile phones to arrange currency exchanges with the "market makers" mentioned in the previous section.[141] Although some resulting deals were crossed legally via the swap markets, illegal premiums were paid under the table to make the deal go through.[142] The resulting currency chaos prompted would-be arbitragers to invest in bogus currency futures agencies.[143]

Bowing to the pressure, the SGAEC removed the cap and trading again resumed at the fervent pace.[144] The *renminbi* stabilized, but only with considerable help from the central government selling off its precious reserves of hard currency at a high thirty percent discount from the official rate.[145]

4. *The Austerity Drive that Failed*

Although discipline was restored to the swap market, internal drives to cool down other economic unrest failed. The savior of the swap markets, former "one-chop" mayor of Shanghai,[146] vice premier Zhu Rongji was appointed governor of the Peoples Bank of China in

139. Sender, *supra* note 11, at 65 (graph indicates a less than one yuan gulf in January 1992 widening to a five yuan gulf in July, 1993).

140. *Id.* at 64-65.

141. *See supra* note 118 and accompanying text. *Cf.* Frisbie & Brecher, *supra* note 59, at 12 ("In the first half of 1993, . . . 18 FIEs (44 percent of the survey sample) reported that they had been approached to buy foreign exchange outside of the swap centers. Nine of the 18 confirmed they completed off-market trades.").

142. Hanneman, *supra* note 72, at 33.

143. The PRC government recently recognized the existence of "illegal foreign exchange shops" which used high-tech equipment to defraud customers in so-called "futures" transactions. *Government Investigates Black Market Foreign Exchange Business in Shenzhen*, BBC Summary of World Broadcasts, Feb. 5, 1994, Part 3 Asia-Pacific, *available in* LEXIS, Asiapc Library, Bbcswb File. The official Chinese English language newspaper reported that residents of Guangzhou province have been cheated out of more than $1.3 million from these illegal shops. Li Wen, *China: Guangdong Curtailing Illicit Trade in Currency*, CHINA DAILY, *in* BUS. WK., Jan. 23, 1994, (China Daily Supp.) *available in* LEXIS, News Library, Reuter File.

144. *Id.*

145. Kaye, *supra* note 109, at 58 (Hong Kong financier estimates the PRC spent over US$300 million to support the *renminbi* in June of 1993 alone).

146. Zhu is renowned for his attempt to reduce the bureaucracy of the city which required many *chops* (the Chinese equivalent of a signature) for projects to go through. Harry Sender, *Paging "Action Man"*, FAR E. ECON. REV., July 15, 1993, at 72.

an attempt to regain control of the economy.[147] Although Zhu vigorously pushed a sixteen point program of reforms (with the help of specially appointed central government teams) cracking down on corrupt practices in lending and spending, the program was largely unsuccessful in improving China's economic problems, including the central-region conflicts.[148] Because of well-placed *guanxi* ("connections") in regional governments, private enterprises evaded the credit rationing, leaving the state run enterprises, China's equivalent of the American welfare system, precariously in debt.[149] For these and other reasons, the austerity drive was abandoned. Zhu's previous success in reigning in the swap markets could not be duplicated in governing the People's Bank.

B. The Change: Foreign Exchange Reforms

Based on the successful rescue of the swap markets, and the failure of other measures, such as the austerity campaign, foreign exchange reform is a natural path for the central government to pursue. By unifying the exchange rates and controlling domestic enterprise access to foreign exchange, the PRC may be able to rein in capital outflows and recentralize control over a greater portion of China's economy.

1. The Unified Rate

On January 1, 1994, the PRC government effectively devalued the official rate for the *renminbi* by thirty-three percent.[150] In a tandem move, the foreign exchange certificate (FEC) was eliminated from circulation.[151] The rate chosen was based on swap market prices prevailing on the last business day before the reform—a realistic, market driven approach to the *renminbi*'s value.[152] The Foreign Exchange

147. *Id.*

148. Walsh, *supra* note 127, at 14-18.

149. Carl Goldstein, *Growth at Any Cost*, FAR E. ECON. REV., Nov. 25, 1993, at 16.

150. Lincoln Kaye, *Deafened by Decree*, FAR E. ECON. REV., Jan. 13, 1994, at 80. *But cf. id.* at 81 (stating that the term devaluation is incorrect because "most foreign exchange dealings were already being conducted at the swap centres' quasi market rate").

151. Foreign Exchange Reforms, *supra* note 2, Part VII. For a discussion of the PRC's handling of the changeover, see Kaye, *supra* note 150, at 80-81 (discussing the confusion amongst FEC holders as the announcement of the demonetization of the FEC was not accompanied by assurances that it would be accepted at the old rate until the FEC was completely phased out; noting how they rushed to spend all their FEC before the announcement was finally made).

152. *Id.*

Reforms dictated eliminating these "dual rates" (i.e. swap and official rates) and adopting a "unified rate."[153]

a. New Interbank System

The unified rate is determined by a new, national inter-bank foreign exchange market comprised of banks authorized to deal in foreign exchange.[154] The promise of an inter-bank market[155] is a move towards a monetary policy in line with other developed countries because it signals a lessening of intervention by the central government. However, because the PRC is not ready to fully float[156] the *renminbi*

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153. Foreign Exchange Reforms, *supra* note 2, Part III. For further reference, the English text of Part III is as follows:

> After the introduction of the systems of selling and buying foreign exchange at the banks, a national unified inter-bank foreign exchange market will be established. The designated foreign exchange banks are main participants in the inter-bank market, whose main functions are to facilitate the matching of long and short foreign exchange positions of different designated banks, and to provide clearing and settlement service for banks. This market is regulated and supervised by the People's Bank of China through the State Administration of Exchange Control.
>
> The dual renminbi exchange rates are to be unified as of January 1, 1994. The unified renminbi exchange rate will become a single, managed floating rate based on market demand and supply of foreign exchange. The People's Bank of China will publish daily the middle rate of renminbi against US dollar according to the transaction price prevailing in the inter-bank foreign exchange market on the previous day, and also, with reference to the changes of the international foreign exchange market, publish the renminbi rates against other major foreign currencies. Based on the foreign exchange rates published by the People's Bank, the designated banks will then list their own exchange rates within the floating range designated by the People's Bank, and purchase or sell foreign exchange to their customers at the listed rates.
>
> With the prerequisite of stabilizing the domestic currency, the listed exchange rates of different banks are to be maintained basically compatible and relatively stable through inter-bank foreign exchange trading and the intervention of the People's Bank through buying and selling foreign exchange in the foreign exchange market.

154. *Id.*

155. It is labeled a "promise" because, as explained below, the inter-bank market created by the PRC reforms differs from what other countries refer to as "inter-bank" trading systems. *China Abolishing the Swap Markets: April Fools?*, Bus. China (Economist Intelligence Unit, New York, N.Y.), Mar. 7, 1994, *available in* LEXIS, World Library, Buschin File [hereinafter *Abolishing Swaps*].

156. Meaning a minimum of government intervention. *See* Weisweiller, *supra* note 24, at 57:

> If there are no parities fixed between the currencies of the world, then rates can float freely; at no particular point is the central bank obliged to interfere. Few people seriously advocate that central banks should not be allowed to intervene in the foreign exchange markets . . . .

as the United States has the dollar, it will maintain certain controls in a "managed float based on market demand and supply."[157]

The main difference between the inter-bank system and the swap market system is that only banks are allowed to trade on the new market, excluding all firms and trading entities, both domestic and foreign funded.[158] The systems are linked electronically so that uniformity in ask and bid (sell and buy) prices should be achieved.[159] Firms that want to purchase or sell foreign exchange will need to contact a designated bank for these transactions.[160]

b. *Fate of the Swap Market System*

At the current stage of the implementation of the Foreign Exchange Reforms, foreign funded firms have been left to continue utilizing the swap markets, though only through foreign and domestic bank brokers.[161] This leaves only designated PRC banks in the inter-bank market.[162] In practice, the separation of the two systems should

There are however, many who prefer the choice of these points to be taken on adhoc basis by the government of the country and not fixed for years ahead.

157. *See* reprinted text of Foreign Exchange Reforms, Part III, *supra* note 153. The level of management in the float became apparent when the People's Bank announced caps on buying and selling rates just before implementation of the inter-bank market (discussed *infra*). *See also* Andrew Quinn, *China Sets Tight Limits to New Forex Trade System*, Reuters World Service, Apr. 2, 1994, *available in* LEXIS, News Library, Allnws File ("The official China Daily said . . . the country's authorised foreign exchange banks could only float their buying and selling rates within 2.5 per 1000 of the central bank benchmark 'to avoid affecting the national economy too much.'").

158. *Abolishing Swaps*, *supra* note 155.

159. *Id.*

160. *Id.*

161. When the inter-bank system opened in April, the initial news dispatch from the Chinese government restricted foreign funded firms from the system without explanation. Gordon Platt, *Foreign Ventures to Be Denied Access to China's Interbank; Enterprises May Use Swap Centers*, J. COM., Apr. 15, 1994, Trade sec., at 3A. Later, the government maintained that "[foreign invested enterprises] do not need the interbank forex market since they do not have to sell their forex receipts to the PBOC and can still have access to the existing swap markets." Sally Gelston, *China: Foreign Exchange System Still in Flux*, E. ASIAN EXECUTIVE REP., Mar. 15, 1994, at 5.

Foreign banks were denied access to the inter-bank system and remain only brokers in the swap markets. Bill Savadove, *New Rules Curb Foreign Bank Trading Of Yuan*, J. COM., Mar. 23, 1994, Front sec., at 2A (noting also that the PRC reneged on a promise to allow them to quote their own currency prices). The scope of foreign bank activities in China is still highly circumscribed, although recent decisions have created new opportunities and opened up new geographic areas. For a concise discussion of the development of foreign banking in the PRC, see Susan M. Cormac, *Foreign Bank Branches on the Move*, CHINA BUS. REV, May/June 1993, at 40-44.

162. However, some of the PRC's larger, multinational corporations have petitioned for entry. *Abolishing Swaps*, *supra* note 155 ("[T]he Ministry of Foreign Trade and Eco-

not result in different exchange rates because the PRC claims to apply a "uniform exchange rate" to both, based on weighted average prices.[163] Since some former swap centers now house both systems,[164] this type of price monitoring is highly feasible. No wide variation has been reported between prices paid at swap markets and the interbank rate.[165]

2. *New Controls for Domestic Entities*

a. *The Surrender System*

Part I of the new foreign exchange rules requires all state enterprises, public institutions, government agencies, and social organizations in China to promptly surrender foreign exchange receipts to designated Foreign Exchange Banks.[166] This is a move of great importance to the PRC's goal of centralizing control, because, if the system is implemented properly by China's domestic banks, the result

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nomic Cooperation (MOFTEC) is putting pressure on the PBOC to allow China's major import-export companies to also have seats in the new foreign exchange markets. The reason is that these huge corporations, with their heavy exchange needs, do not want to work through banks—they want to be players in the market themselves.").

163. *China Refutes US on Exchange System*, XINHUA NEWS AGENCY NEWS BULL., Aug. 11, 1994 (based on statement of People's Bank of China spokesperson), *available in* LEXIS, News Library, Xinhua File.

164. Tony Walker, *Quiet Debut for New China Market*, FIN. TIMES, Apr. 5, 1994, at 4 (describing the new national center in Shanghai):

> A foreign banker in Shanghai said that the new [Shanghai] interbank market was effectively a "three-in-one" market. It would serve for the time being as a "swap centre" for joint ventures, an interbank market for Chinese institutions and as a market for foreign banks restricted to selling foreign currency on behalf of Chinese customers. Joint venture customers are being confined to swap centre trading for the time being in an apparent attempt to lessen pressures on the market in its early phase.

165. Reports have indicated the swap markets have been relatively stable. Anne Stevenson-Yang, *Swap Centers Still Open for Business*, CHINA BUS. REV., May/June 1994, at 4 ("In April, reports from companies in Beijing suggested that the swap markets were functioning as usual, with some companies denied access and others permitted to swap only pre-determined amounts. No company, however, reported any significant change in the available supply of foreign exchange."). However, should the rates tend to escalate again, intervention by the government in stabilizing the swap rates is highly likely, with the government opening up its reserves as it did in the 1993 crisis. Kaye, *supra* note 109, at 58 (cites unofficial estimate of US$300 million spent to prop up the swap markets).

166. Foreign Exchange Reforms, *supra* note 2 (Part I is entitled "To implement the system of selling off foreign exchange receipts to the banks and abolish foreign exchange retention system.").

will be a framework where firms cannot as easily stockpile foreign exchange proceeds for later speculative purposes or capital flight.[167]

What the banks are to do with the foreign exchange surrendered depends upon how the receipts were generated, the receipts falling into two general categories. The first category of foreign exchange represents most of the large, market-oriented types of proceeds arising from trade, PRC service providers, and investment abroad.[168] The central government intends to consolidate its control over this type of foreign exchange by requiring it to be sold to officially sanctioned banks for *renminbi*, based on the current rate of exchange listed by the banks.[169] Thus, Chinese firms with substantial foreign exchange proceeds will be prevented from spending them without first surrendering them for *renminbi*, and then using the *renminbi* to purchase foreign exchange at the outstanding official exchange rate (possibly reflecting depreciation). This procedure theoretically creates a paper trail for the central government to track capital flows.

The other category of foreign exchange receipts consists of foreign exchange sources passive in nature or small in volume such as investment, donations, and individual use.[170] Foreign exchange within

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167. This analysis assumes that China's central bank will ensure that the banks designated to handle foreign exchange will heed its commands. For a discussion of the issue of China's control over its banking system, see sources cited *supra* note 126 and accompanying text. One economist has told the author that the banks have been following the dictates of the Foreign Exchange Reforms, although he noted that the exchange risk may lead more Chinese firms to attempt to funnel foreign exchange offshore. Telephone Interview with Guocang Huan, Senior Economist (Northeast Asia), J.P. Morgan (Hong Kong Office) (Aug. 29, 1994).

168. The category consists of exchange receipts from:

> (1) Foreign exchange earnings from exports, transit trade and other trading activities; (2) Foreign exchange earnings from services provided by communication and transportation, post and telecommunications, tourism, insurance, and other service industries, and from intergovernmental transfer; (3) Net foreign exchange proceeds from foreign exchange operations of the banks, which are required to be turned over to the State, and foreign exchange returns received from overseas service contracts, and from investment abroad which are subject to repatriation; and (4) Other foreign exchange receipts which are required to be sold off to banks pursuant to the regulations of the exchange control administration.

Foreign Exchange Reforms, *supra* note 2, Part I. Note the catchall provision in the fourth clause above, which provides for future latitude in this category.

169. *Id.*

170. The complete list consists of:

> (1) Foreign exchange remittance to China for the purpose of investment by non-resident legal entities or natural persons; (2) Foreign exchange received from external borrowing, and debt or equity issuance; (3) Funds remitted back to China by the service contracts companies within the contract period of their overseas projects for current use of the project; (4) Receipts from foreign donations and

these sub-categories is permitted to be held as such in accounts opened with designated foreign exchange banks.[171] To prevent abuse of the benefits of this categorization, the Bank of China announced intentions to set up special sections to examine the documents of those claiming this category.[172]

In adopting a system of foreign exchange surrender, the PRC has expressly and necessarily abolished previous foreign exchange retention procedures and official foreign exchange quotas for state run firms.[173] Under the retention system (discussed above in connection with the swap markets) state firms were allowed to open foreign exchange cash accounts depositing foreign exchange earnings and maintaining the proprietary right to use the foreign exchange or exchange it with other entities for *renminbi*.[174] With the reforms, this procedure ends and such firms no longer have the proprietary right to foreign exchange earned from exporting activities or trading in the swap market. Nor will enterprises be given foreign exchange quotas under the state plan. Instead they will have to purchase it from the designated banks based on the access controls described below.[175]

> grants approved for specific purposes; (5) Foreign exchange receipts of diplomatic missions, and residence offices of international organizations and other nonresident legal entities in China; and (6) Foreign exchange held by individuals.

Foreign Exchange Reforms, *supra* note 2, Part I.

171. *Id.*

172. *China Steps Up Efforts to Limit Access to Foreign Currency*, UPI, Jan. 13, 1994, *available in* LEXIS, News Library, UPI File (Based on statement of Wang Qiren, president of the Bank of China).

173. Foreign Exchange Reforms, *supra* note 2, Part I. As a transition mechanism, retained foreign exchange and quotas uncommitted as of the date of reform could be converted at the high official rate of December 31, 1993. New deposits into these accounts, however, were prohibited. *Id.*

174. Kaye, *supra* note 150, at 81.

175. As an interim measure, domestic enterprises have been allowed to keep "record keeping accounts" which allow firms direct access of up to 50% of the foreign exchange deposited with the proper documents. Foreign Exchange Reforms, *supra* note 2, Part II. This eliminates the risk of the currency depreciating in the future. The remaining 50% must be surrendered in exchange for *renminbi*. *Id.* One senior economist has described this situation as "double risk." First, the domestic firm loses 50% of its foreign exchange immediately upon surrender, and must then purchase foreign exchange later (at a possibly higher exchange rate) with *renminbi*; second, it is uncertain when PRC policy changes might force the enterprises to surrender the other 50% in the desk account (record keeping account). Interview with Guocang Huan, *supra* note 167.

b. *Gaining Access*

In place of the retention system, the Foreign Exchange Reforms institute a tightly controlled system for access to foreign exchange.[176] To purchase foreign exchange for commercial payments, enterprises must provide the domestic banks with verifiable documentation. Chinese domestic enterprises, public institutions, government agencies, and social organizations can get foreign exchange for these "external payments under the current account"[177] with the following documentation:

(1) Import quota, license, or other import authorization issued by the departments concerned and relevant import contract for those items subject to import quota or import restrictions;[178]

(2) Registration verification and relevant import contract for those items subject to import voluntary registration;[179]

(3) Import contract and notification for payment from overseas financial institutions for all other import items than the above two categories, which are in conformity with the State regulations;[180] and

(4) Payment agreement or contract, and notification for payment from overseas financial and non-financial institutions for commercial payment under the non-trade account.[181]

These requirements transfer control over the access of foreign exchange for commercial payments from the SGAEC and regional banks to China's trade ministry (the agency in charge of import registration and contract approval). This change in authority arguably reflects the PRC's concerns over capital flight and frivolous imports. The procedures for accessing foreign exchange for non-commercial payments have not changed.[182]

176. Foreign Exchange Reforms, *supra* note 2, Part II (entitled "To implement the system of purchasing foreign exchange from the banks and make the renminbi conditionally convertible under the current account").

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. Foreign Exchange Reforms, *supra* note 2, Part II. That section reads:

> Purchase of foreign exchange for non-commercial payments or for withdrawal of foreign currency in cash shall be proceeded in accordance with the relevant regulations on financial and foreign exchange control. The authorization procedures shall continue to be in effect for foreign exchange remittance for making overseas investment, lending, and donations.

The commercial access requirements will also end the power of certain state owned enterprises to manipulate the foreign exchange market.[183] Although the PRC professes to have weaned most of its state owned enterprises off the official rate (and into the swap markets),[184] some unaffected enterprises could still sell their foreign exchange to smaller domestic entities at a profit, acting as "money changers."[185] Many enterprises sat legally and illegally on accumulations of foreign exchange, in expectation of another *yuan* devaluation.[186] As mentioned above, because they were allowed to buy foreign exchange at the official rate and then rely on this rate to buy necessary raw materials at discount prices, these firms also had a subsidy of nearly thirty percent compared to firms tied to the swap market.[187]

With the new reforms, the government can, in theory, fully control the flow of foreign exchange both in and out of China and prevent uneven distribution to certain provinces.[188] The reforms in control over domestic firm access to foreign exchange have played a major part in increasing China's foreign exchange reserves.[189] However, the reforms may also precipitate more foreign exchange outflows as "false foreign ventures"[190] increase when companies try to lower the risks of

183. Yu Juan, *supra* note 110, at 26.

184. *See* Kaye, *supra* note 150, at 81:

> Among the minority of trading at the fixed rate was the US$300 million worth of FEC, as well as an unspecified amount of state-enterprise entitlements to buy foreign exchange at the preferred rate from the BOC [Bank of China]. Nearly two-thirds of those entitlements were withdrawn by government fiat last July [1993].

185. *Id.*

186. Andrew Browne, *China's Zhu Rongji Pledges Stable Exchange Rate*, Reuter Newswire, Aug. 4, 1993, *available in* WL, Int-News Database.

187. The difference between the prevailing swap rate before the change and the concurrent official rate.

188. Yu Juan, *supra* note 110, at 26 ("Beijing leaders hold that the new ruling can break the hitherto uneven distribution of foreign currencies in China's 30 provinces and regions, where certain places have surplus currencies while others in need of them do not.").

189. Carl Goldstein, *Economic Monitor: China, A Thousand Thanks*, FAR E. ECON. REV., June 30, 1994, at 44 (comparing a rise from US$21.2 billion at the end 1993 with US$27.2 billion on March 31, 1994); Andrew Browne, *Abolition Of China Rate Leads to Jump In Reserves*, J. COM., Apr. 20, 1994, Front sec., at 2A (SGAEC official labels it "biggest jump in history"). *But see* Goldstein, *supra* at 45 (Xiao Geng, an economics lecturer at the University of Hong Kong, cites credit restrictions issued the first quarter of 1994 as the impetus for increased reserves: "When enterprises couldn't get money from the banks, they had to sell foreign exchange they'd been holding.").

190. *See supra* Part III.A.1.

the surrender system by funneling some of the foreign exchange into the "foreign" partner's account.[191]

IV. Effects on Foreign Direct Investment

Two prominent PRC officials have explicitly stated that the new reforms will have no effect on the operation of foreign funded enterprises.[192] Although the directives of the Foreign Exchange Reforms do not present new alternatives to the methods discussed in Part II.B.3 for solving foreign exchange problems, the reforms will streamline administration of foreign invested enterprises. A negative impact may be a loss of the flexibility found in the swap markets.

A. Impact on Administration

The set up and administration of foreign direct investment will be easier, due to the abolition of the foreign exchange certificate (FEC) and the discriminatory system of requiring foreign capital to be registered at the official rate. Without the obligatory FEC, accountants no longer need to keep separate balance accounts of *renminbi* and FEC purchases. Unfortunately, the PRC bypassed an opportunity to put foreigners and Chinese on equal footing after the abolition of the foreign exchange certificate when it allowed government agencies to raise the prices of the wages, rents, and other services that were formerly paid in FEC.[193]

Accountants and negotiators should also welcome the devaluation of the *renminbi*. Negotiators of Sino-foreign joint ventures previously had to bargain hard for increased valuation of foreign contributions of technology and equipment because of the registration

191. For a discussion of these risks, see *supra* note 167.

192. The first individual is the Minister of MOFERT, Wu Yi. *China: Foreign Trade Minister on Foreign Exchange Reform and Its Impact on the Trade System*, BBC MONITORING SERVICE, Jan. 5, 1994, *available in* WL, Int-news Database ("the way to manage foreign exchange for foreign funded enterprises remains unchanged."). The second is the vice-president of the People's Bank of China, Zhou Zhenqing. *Foreign Exchange System Unified in Move Towards a Convertible Currency*, BBC SUMMARY OF WORLD BROADCASTS, Dec. 31, 1993, *available in* LEXIS, Asiapc Library, Bbcswb File ("[C]urrent foreign exchange measures regarding foreign funded enterprises within our national boarders will remain unchanged.").

193. Kathy Chen, *Foreign Firms in China Oppose New Surcharges*, WALL ST. J., Feb. 7, 1994, at A11 ("Business groups representing hundreds of U.S., European and Asian companies have sent letters to top Chinese leaders to protest what they describe as 'discriminatory' 50 percent increases on phone rates, salaries of Chinese employees and other charges.").

of these items at the overvalued official rate.[194] Accountants not only had to keep track of these valuations, but in order to deal with the 1992 and 1993 depreciation of the *renminbi*, they had to translate it back into hard currency in order to determine if there were earnings or losses.[195] This headache should also end, assuming the currency remains stable.[196]

Other expected benefits to the administration of foreign funded enterprises in China are an expansion of foreign exchange liquidity and an increase in the speed of foreign exchange transactions because of the electronic interlink between centers.[197] Because of this, the regional variation in exchange rates at swap centers should cease.[198] Foreign exchange can follow demand around the whole of China.[199] Another side benefit of the electronic linking should be increased speed in the settlement of foreign exchange transactions.[200]

B. *Possible Loss of Flexibility*

On a negative note, should the PRC abandon the current policy of allowing foreign funded ventures to use the swap markets and force these firms to use the inter-bank system, the current flexibility the swaps offer will be lost. Shortly after the reforms, before the inter-bank system was established, it was reported that state bank branches were already directed to limit Chinese enterprise's access to foreign

194. These negotiations used to be "dealbreakers" according to an American attorney in China. Sender, *supra* note 11, at 64 (statement of David Ho of Baker & McKenzie). *See also* Henny Sender, *At Your Service: China's Lenders Remain Political Puppets*, FAR E. ECON. REV., Jul. 7, 1994, at 62 ("[D]eals are easier to do now that the Chinese side can no longer use an unrealistic exchange rate to inflate its contribution.").

195. Sender, *supra* note 11, at 65 ("[T]heir balance sheets may be denominated in renminbi. But their footnotes, at least, will have to show the value of their assets and earnings in hard currency.").

196. One financial expert has predicted a possible drop in the swap market rates. Sender, *supra* note 194, at 62 (In light of low trading volumes on the swap markets, Huan Guocang of J.P. Morgan in Hong Kong states that "if the government does not intervene, the rate could drop to Rmb 9.5 or 10 [down from 8.7] to the dollar.").

197. *Abolishing Swaps*, *supra* note 155.

198. *Id.* For a discussion of the regional variations, see *supra* note 70 and accompanying text.

199. *Abolishing Swaps*, *supra* note 154.

200. *Id.*

> Although settlement will not always be immediate, companies should be able to buy and sell currency more quickly. The overnight settlement system ought to mean that even large orders can be met the day after they are placed. Last year [1993] many companies waited one or two weeks for foreign exchange transactions; some did not get them at all.

exchange.[201] Increased involvement by the central government in the approval process for foreign funded firm access to foreign exchange, as opposed to the more local swap centers, could mean tight implementation and monitoring of the balancing requirements discussed above.[202] The government could, as it has promised with the state enterprises, closely scrutinize the standing of foreign funded firms to receive foreign exchange.[203]

The practice of flexible pricing, which some claim has proven to be invaluable to certain foreign invested enterprises balancing their foreign exchange, may also be hampered. Without retention quotas of foreign exchange at their disposal, PRC state owned enterprises may not be able to continue purchasing goods in China for foreign exchange. An unanswered question remains as to how firms that have relied on this system will manage if it collapses.

C. A More Stable Renminbi

In the larger picture, the foreign exchange reforms could offer foreign investors increased stability in the foreign exchange area. Implemented as planned, the reforms could curb illegal capital flight (by making it easier to track foreign exchange flows) and ensure that more foreign exchange is accessible for production-oriented enterprises.[204] The positive effect on the PRC's foreign exchange reserves,

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201. Carl Goldstein, *A Lighter Shade of Red*, FAR E. ECON. REV, Apr. 28, 1994 at 79.

202. State Administration of Exchange Control officials have already been expressing concerns over the loose treatment of some foreign invested enterprises. Stevenson-Yang, *supra* note 165, at 4:

> Yang Gonglin, SAEC director of policy and regulation, expressed concern that some FIEs have not invested all their contracted capital, while others have failed to meet export commitments in their contracts. He suggested that future breaches of such standards would result in an FIE being denied permission to purchase foreign currency. Yang also said, however, that a company meeting all its contractual provisions should face no barriers to buying hard currency.

See also Abolishing Swaps, *supra* note 155 ("It is possible, even probable, that the PBOC's new [promised] regulations [designed to further implement the Foreign Exchange Reforms] will force banks to look more closely at companies' justification for foreign exchange orders than did swap centres. The banks may be asked to enforce foreign exchange balancing requirements more strictly.").

203. *Id.* (speculating that "Companies, including—though they usually deny it—American and European ones, that used to enjoy special, queue-jumping relationships with swap centres will lose them.").

204. *See* Brauchli, *supra* note 6, at A12:

> Numbers recently released by the government suggest that its efforts may be deterring undesirable foreign investments . . . . [G]overnment-run media said the number of new foreign-backed enterprises plunged 44%, or by 10,739 registrations, in the first three months of 1994 from a year earlier. . . . [T]he China Daily

which are an indicator of the stability of a country's currency, has already been witnessed.

V. Conclusion

In sum, the Foreign Exchange Reforms discussed in this article represent a move by China to recentralize control over a most important asset, money. The move was made in response to China's high levels of legal and illegal capital outflows and China's wealthier regions using their foreign exchange to ignore and evade dictates from the central government. The government has designed the new controls over foreign exchange to strictly regulate the access to hard currency. The creation of the inter-bank market will also allow the PRC to oversee the value of the *renminbi* without the need for the buffer currency known as the FEC.

Unfortunately, the PRC has still maintained its tight controls on the ability of foreign funded enterprises to access foreign exchange. The Foreign Exchange Reforms offer some help in this area, mainly by ending the use of the former official rate in the negotiation and administration of foreign funded firms. However, the benefit of stability in the exchange rate resulting from the reforms may be offset by the loss of flexibility in access enjoyed at the swap markets.

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newspaper said the drop in foreign-company registrations resulted mainly from a decline in "bogus joint ventures." Analysts said such ventures probably include companies most responsible for a boom in speculative real-estate investment and luxury-automobile purchases.